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BOOSTING AFRICA'S GROWTH THROUGH RE-INJECTING "SURPLUS" OIL REVENUE
An alternative to the traditional advice to save and stabilize

Report by the UNCTAD secretariat

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Executive summary

Compared with the previous decade, oil prices were very high in 2004 and 2005, and have been very high so far in 2006, and everything indicates they will remain high for the foreseeable future — well above the $20–25 a barrel reference price on which most Governments of African oil-exporting countries were basing their budget decisions in the early years of the decade.

The traditional advice to these Governments is that they should save the “surplus” revenue — that is, put it into a stabilization fund, which is invested safely in the OECD capital market, to act as a buffer in future years when prices are lower, and for use by future generations. This report argues that this is not the best advice. The stabilization fund strategy has by and large failed to deliver on its promises in the past; but more importantly, Africa has considerable investment needs that can be met by this surplus revenue. The Governments of African oil exporters should re-inject at least part of their revenue surplus into strategic investments in Africa’s future.

The logical counter-argument is that in the past, African Governments have proved to be rather bad at investing oil revenue. Earlier oil booms resulted in many economically unviable projects and heavy debt burdens. Precisely for this reason, this paper argues for a novel approach: the Governments of African oil-exporting countries should put part of their surplus capital (perhaps amounting to several billion US dollars, which would still only be a tenth of their current annual share in oil export earnings) into a series of professionally managed investment funds. Although the Governments would provide the capital, they would have no influence on investment decisions. There is no lack of African nationals working at high levels in the world’s financial markets, including in the large Western investment banks, and recruiting high-calibre staff to manage such funds professionally, without political interference and according to the highest standards of integrity and transparency, would not be difficult.

These investment funds would invest in infrastructure and services critical for Africa’s growth and competitiveness. These include the large projects identified in the framework of NEPAD, as well as many smaller projects, for example in transport-related infrastructure, energy distribution networks and trade-related services. In the 1990s, the returns on private investments in Africa were more than 20 per cent (higher than in Asia and Latin America); this indicates that there is a large pool of potential projects in which it is worth investing. The ownership of the funds by African Governments would give them an important comparative advantage compared with the (much smaller) Western investment funds that now exist, in that political risk factors would play a much reduced role. This would, in effect, allow the funds to leverage their own capital, mitigating the risks in projects and thus attracting supplementary new finance from the Western capital market.

While not all investments would be successful, it could be expected that the returns from this strategy would easily exceed those derived from putting “surplus” funds in OECD bank accounts. And by investing in Africa’s economy and trade infrastructure as a whole (rather than just in their own countries), African oil exporters would support regional integration on the continent and create new opportunities for their countries’ non-oil exporters. Importantly, the creation of funds of this nature would signal to international capital providers that African leaders believe in the future of their continent, and are willing to "put their money where their mouths are". The creation of these funds could considerably boost Africa’s growth and competitiveness, even in the short run, making it more likely that the continent could reach the growth rates necessary for meeting the Millennium Development Goals.

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INTRODUCTION

1. Crude oil is Africa's largest export, and while the current high prices have strong negative effects on the many net oil-importing countries in the region, for Africa as a whole they provide an unprecedented opportunity. While part of the benefits of the oil price increase has accrued to the (mostly non-African) private sector operators that are active in the sector, most of them have gone to African Governments.

2. These Governments are under pressure from their generally poor populations — not to mention many less representative local pressure groups — to spend this money. Understandably, given the often poor record of African Governments in spending export windfall gains, international financial organizations caution them against this. For example, in 2004, the Managing Director of the IMF, Rodrigo de Rato, warned African countries against squandering the current windfall from oil sales, saying that for countries rich in mineral resources "a key priority is to avoid boom–bust cycles as oil prices rise and fall. This will require that much of the revenue windfall from high prices be saved and incorporated into a medium-term fiscal framework aimed at achieving fiscal and debt sustainability."[1]

3. However, such advice is based more on governance considerations than on economic ones. Economically, much of the windfall gains should be invested in Africa: investment capital is scarce in the region and can thus attract high returns. As long as their economies can absorb investments, and these investments are sufficiently profitable (as compared with other investment opportunities), there is no economic reason to park windfall gains in developed country financial centres. Governments also have a strong strategic reason for investing these funds in their own economies (which, as will be discussed in chapter I, implies a regional perspective). Oil and gas are dwindling resources, very rapidly so in a number of African countries, whose known reserves will run out within two or three decades. Governments have a duty to ensure that, before they are depleted, new economic clusters have sprung up to take their place, as generators of employment, national income, government revenue and export earnings.

4. In the current environment in much of Africa (where countries generally rank in the lower half of the international comparisons of levels of corruption and strength of public institutions[2]), there are strong governance-related concerns about investment spending. Unfortunately, governance-related concerns are often confused with economic ones. This can be illustrated by the words of a senior World Bank official: "Over time there has been a shift in the emphasis of what 'Dutch Disease' really means. At the beginning, the disease was thought of in terms of real exchange rate appreciation and growth of the non-traded sector relative to non-oil tradeables. Then the emphasis moved on towards issues of instability and poor macro-economic management. Most recently it has moved further, towards the question of political and social institutions and their tendency to deteriorate when revenues rise. There has been a progression in our understanding of what the nature of the problem really is."[3]

5. This confusion of economic issues with governance issues is not helpful: it does not allow problems to be addressed and to be solved in a pragmatic manner. This short paper discusses an

[1] Rodrigo de Rato, *A Partnership for Growth and Poverty Reduction in Africa*, Extraordinary Summit of the African Union, Ouagadougou, 8 September 2004.
[2] World Economic Forum, *Global Competitiveness Report 2005–2006.*
[3] Alan Gelb, Chief Economist, Africa Region, World Bank Group, in a presentation at the World Bank/UNDP Workshop on Petroleum Revenue Management, Washington, DC, 23–24 October 2002.

alternative approach that allows African Governments to make an economically optimal decision on how to use windfall gains while avoiding governance problems. Instead of investing funds themselves, or saving them in developed country financial markets, there is a third way: African Governments can create a professionally managed investment fund (or a set of such funds). One or more Governments would put up the capital of the fund out of part of the windfall earnings, but would not exercise day-to-day management and, indeed, would not influence the investment decisions of the fund managers.

6. An important focus of such an investment fund should be energy infrastructure. While more than half a billion Africans currently have no access to electricity, at current investment levels this number will increase to 580 million people over the next 25 years.[4] This is detrimental to Africa's growth prospects, its ability to meet the Millennium Development Goals and its social stability. To quote from a World Bank website:[5]

> "Reasonable macroeconomic stability — a prerequisite for sustainable growth — is simply not compatible with a non-viable, vulnerable energy sector. There are no examples of where macro-economic stability has been sustained under these conditions.
>
> "It is increasingly apparent that Africa's poor are denied possibilities to invest in their own development and denied opportunities to grow economically through their lack of access to infrastructure, including the services which modern energy provides."

7. While the size of the investment needs in this sector is beyond the capacity of African Governments, by putting their own funds at the forefront of the fight against energy sector deficiencies these Governments will give a clearly positive signal to outside investors, and can thus expect their investments to have a strong leverage effect.

8. The investing of African Governments' money in professionally managed investment funds has a further benefit: it will strengthen the policy feedback to those Governments. One argument against giving African Governments much leeway in spending surplus revenue is that this reduces their incentive to reduce corruption, reform poor policies and improve the generally unsupportive business environment. But the presence of these professional funds will have exactly the opposite effects: fund managers will have easy access to senior policymakers, and through both their words and their action (i.e. their decision to invest more in certain countries than in others) will be able to put pressure on Governments to improve their countries' business climates.

9. This short paper examines the key issues surrounding the use of African surplus revenue for creating African investment funds. Chapter I discusses the issue of absorbing windfall profits, and in particular the experience with stabilization funds. Chapter II discusses how an investment fund could be set up and how it would function — to be exact, it should be what is known as an "umbrella fund", investing in a series of funds which all have different investment strategies. A final section concludes the paper.

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[4] Fatih Birol, International Energy Agency, "Africa in a global context: The energy outlook", *African Oil and Gas: The New Horizon*, PetroSA and PriceWaterhouseCoopers, 2005.
[5] World Bank website, *A Brighter Future? Energy in Africa's Development*, http://www.worldbank.org/html/fpd/energy/subenergy/energyinafrica.htm.

Chapter I

ABSORBING "SURPLUS" OIL REVENUE: TRADITIONAL APPROACHES AND THEIR DISADVANTAGES

A. The significance of current high oil prices for government income

10. Oil prices have reached unprecedented heights in nominal terms. In real terms, they are still lower than the mid-1970s, but at that time few African countries were exporting significant amounts of oil. Now they do, and the impact of higher prices on export earnings and government revenue has been very large.

11. Part of the countries' incremental revenue — comparing, for example, 2004 earnings with those of 2003 — accrues to foreign investors; some (a minor part) to local companies; and a large part to Governments, in the form of taxes, royalties and production shares. The exact distribution depends primarily on the agreements in place between Governments and foreign investors and the details of joint venture arrangements. Table 1 gives an estimate of the government revenues of Africa's oil exporters in 2004 as compared with 2003. These figures imply that about half of the extra oil revenue of those countries went to Governments, with some countries (e.g. Nigeria) doing better than others.

12. One can legitimately call the surplus of 2004 earnings over 2003 earnings a windfall. The 2004 windfall gains are comparable to the levels of foreign direct investment (FDI) in Africa in the previous years, and are higher than bilateral development grants to the region. If properly invested and leveraged, these funds would allow Africa to fill much of its infrastructure investment needs gap.[6] According to the International Energy Agency, to supply electricity to the 77 per cent of sub-Saharan Africa's population who do not currently have access to it, a total of $270 billion is needed between 2003 and 2030, or some $10 billion a year.[7] Thus, while in themselves these windfall earnings are not sufficient to fill the whole "investment gap", they are significant; and using even one tenth of them to establish a series of investment funds will have a meaningful impact.

B. Are stabilization funds the best way to deal with windfall earnings?

13. Stabilization funds (also called natural resource funds; they go by different names in different countries) are a standard component of the policy advice for oil- and mineral-dependent economies. Several oil-exporting states and countries have, or had in the past, stabilization funds of various types. These include Alberta's Heritage Savings Trust Fund, Alaska's Permanent Fund, Kuwait's Reserve Fund for Future Generations, Norway's State Petroleum Fund, Oman's State General Reserve Fund and Venezuela's Macro-Economic General Reserve Fund. The

[6] In sub-Saharan Africa, annual infrastructure needs are $17–22 billion, while the annual spending (domestic and foreign, public and private) is about $10 billion. The region's infrastructure financing gap is thus $7–12 billion per year (Task Team on Infrastructure for Poverty Reduction, Development Co-operation Directorate, *Guiding Principles on using Infrastructure to reduce Poverty*, OECD, March 2006).

[7] IEA, *World Energy Investment Outlook 2003*. The report states that "the required investment is most unlikely to be taken up by the private sector". Some form of public–private partnership would be necessary, including government/donor support for subsidizing electricity consumption of low-income populations. This is not unduly expensive. According to this same IEA report, "subsidising the basic needs of 1.4 billion people, assuming a price of 7 cents per kWh (higher than the average in the countries concerned) would require expenditure of $ 1.1 billion per year ($ 600 million in sub-Saharan Africa and $ 500 million in South Asia)".

creation of the fund was often seen as a solution towards "meeting the challenge of the resource curse":[8]

> "The central question around the management of natural resource revenues is 'what to spend and what to save'? Controlling the rate of expenditure in the face of 'windfall' revenues is needed to avoid 'stop-go' public spending, unsustainable 'boom-based' foreign borrowing, Dutch disease effects, consumptive rather than productive investment, exchange rate appreciation, rent seeking, corruption, and a disincentive to private sector investment. The 'savings' question is both about saving for short- and medium-term stabilisation and fiscal budgets, and long-term saving for intergenerational equity."

14. Stabilization funds are unfortunately not the easy solution to the problems of oil- and mineral-dependent economies. For one, they have generally failed to meet their proponents' expectations.[9] Furthermore, it seems somewhat callous to focus on shifting savings out of the region in economies that are held back by serious deficiencies in infrastructure.[10]

15. Stabilization funds have generally, but not always, failed.[11] There has been no discernible impact on government spending, no avoidance of price shocks including Dutch disease effects, and so on. In countries such as Oman and Venezuela, frequent changes to rules and deviations from objectives led to their funds' failure. In Alaska, easy access to the stabilization fund to boost the population's income postponed a response to the state's structural problems: falling oil production and inability to develop other sectors. In other countries, funds intended for earnings stabilization were simply no longer there when the need for stabilization came, as politicians had found other uses for them. There are a number of good reasons for funds to fail, linked not just to the inherent difficulties of managing these funds, but also the unpredictable nature of commodity prices.[12] Possibly, funds that use risk management markets can function better in terms of isolating the country and its Governments from the impact of volatile world markets[13], but as only a part of windfall earnings would then be absorbed by a fund, properly spending these earnings becomes even more of an issue.

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[8] Programme on Business and Development Performance, Overseas Development Institute (ODI), *Meeting the Challenge of the Resource Curse: International Experiences in Managing the Risks and Realising the Opportunities of Non-Renewable Natural Resource Revenue Management*, January 2006.

[9] See, for example, the discussions of the UNDP/World Bank's Petroleum Revenue Management Workshop, 23–24 October 2002.

[10] In a closed economy, higher savings automatically translate into higher investments, but in an open economy savings by an African Government do not necessarily lead to investments in Africa.

[11] See for an overview Davis et al., "Oil funds: Problems posing as solutions?" *Finance & Development*, vol. 38, no. 4, Washington, DC, 2001; and J. Davis, R. Ossowski, J. Daniel and S. Barnett, *Stabilization and Savings Funds for Nonrenewable Resources: Experiences and Fiscal Policy Implications*, IMF Occasional Paper 205, Washington, DC, 2001.

[12] Oil prices do revert to a long-term trend, but to all intents and purposes, this takes so much time that stabilization funds which use a formula to determine when to pay into the fund, and when to transfer funds into the government budget, inescapably run into problems. But without clear rules, transfer decisions will become politicized.

[13] Stabilization funds could be kept small, and thus less prone to external pressures, by externalizing large price risks to futures and over-the-counter risk management markets. See, for a discussion, Stijn Claessens and Panos Varangis , *Oil Price Instability,Hedging, and An Oil Stabilization F und :The Case of Venezuela*, World Bank Policy Research Working Paper 1290, April 1994; and *Macroeconomic Risks in Nigeria: Dealing with External Risk*s, Africa Region Findings No. 30, January 1995.

16. It is evident that is not necessary to save windfall gains outside the country in order to avoid Dutch disease effects. Indeed, policy should take the risk of such effects into account, and it may be necessary to put limits on investments in certain sectors in certain countries. But it is illogical to argue that foreign investors would not cause Dutch disease effect, but local investors would. One cannot at the same time call for new investments and/or new aid flows for Africa ($25 billion a year, according to Tony Blair's Commission for Africa) and suggest to African Governments that they save oil windfall gains abroad in order to avoid inflation.

17. It should also be noted that "productive investment that encourages an increase in the 'supply response' of the economy is optimal in preventing Dutch Disease effects".[14] Some stabilization funds completely ignore this reality. For example, in Sao Tome and Principe, the proposed fund (which is expected to become operational in 2011, when the country's oil exports start) is prohibited from investing in the country's territory.[15]

18. The proposed African investment fund avoids most of the problems referred to in the beginning of this section. With respect to the "expenditure" side of the problem, as decisions on use of the money will be in the hands of professional investment managers, problems such as stop-go public spending or rent seeking are avoided; only Dutch disease effects (in the narrow economic sense) and exchange rate appreciation remain as possible problems, but if a sufficiently large part of the investments improve the country's "supply response", these problems can also be avoided. Fiscal budgets will not be destabilized by the fund, and, certainly, intergenerational equity is better served by building up the country's productive sector rather than leaving the next generation only with extra money to spend on consumption.

C. Investment needs in Africa

19. The current weak infrastructure in Africa results in high costs for investments and trade, and makes it difficult for African entrepreneurs to develop competitive businesses. Weak energy infrastructure is a key part of the problem. It creates a considerable extra cost for entrepreneurs and an important entry barrier for those unable to afford their own diesel-operated generator.

20. A report from Ghana illustrates the crucial importance of energy infrastructure:[16]

> "On the outskirts of Accra, Ghana, business plans are only as final as the next electricity outage permits. In July, food tins at the Prime Pak canning factory were positioned on the assembly line, ready to be sealed before export. Without warning, the machines came to a screeching halt, leaving entrepreneur Cyril Francis standing helplessly in the dark. Thirty per cent of the consignment spoiled.

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[14] ODI, op. cit. It gives as examples the development of a national road network, which contributes to economic growth without increasing the real exchange rate, or irrigation and water systems in rural areas, which stimulate local economic growth.

[15] "It is prohibited to invest the Oil Revenues deposited in the Oil Accounts in investments domiciled in Sao Tome and Principe, or in any investments controlled directly or indirectly, totally or partially, by any national Person, whether or not resident of Sao Tome and Principe" (unofficial translation of Article 13.5 of the Oil Revenue Law, 2004); see http://www.earthinstitute.columbia.edu/cgsd/STP/documents/oilrevenuemanagementlawgazetted_000.pdf.

[16] *Africa Renewal* ,vol. 18, no. 4, January 2005.

> " 'The worst part is not knowing when the blackouts will hit. When you least expect it, everything comes to a standstill', Mr. Francis told *Africa Renewal* from his factory, based in Dodowa, on the fringes of Ghana's capital city. 'It is so frustrating and damaging to business production, not to mention our reputation with people who depend on us to deliver orders on time.' ”

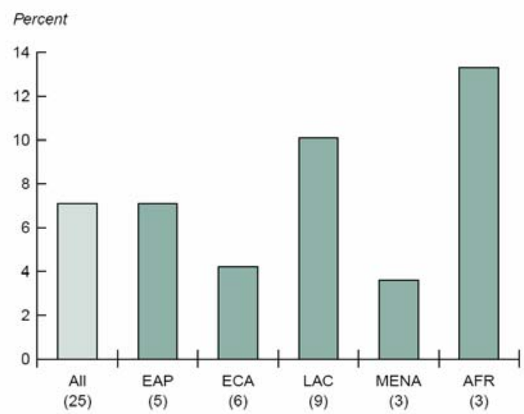
21. Investing in critical infrastructure will eliminate bottlenecks that are now handicapping African entrepreneurs. Not only the investor’s returns, but also social returns on investments will be high. Such investments will in effect improve absorptive capacity by improving efficiency and unlocking entrepreneurial energy.

22. To generate the necessary levels of investment, some form of public leadership is necessary. In the 1990s, many power sector investors were interested in developing country investments, but a series of problems in the industry (including those linked to the collapse of Enron) and greater concerns about the reputational risks of developing country investments led to a substantial decline in such interest after 2001. Having an African investment fund, supported by African Governments, to take the lead in energy investments is one way of reversing this negative trend.

23. Meeting Africa’s investment needs is not incompatible with earning acceptable returns on investment. Africa has very high investment returns, by all estimates. Figure 1 gives an overview based on IMF statistics.

24. According to UNCTAD surveys, the African subsidiaries of US companies reported, between 1990 and 2002, average annual returns of 25 per cent compared with a world average of 12 per cent. Their Japanese counterparts made three times more profit on their African investments than elsewhere. These high profits apply to mining and oil as well as to manufacturing and tertiary industries.[17] A 2000 evaluation by the US Government of its Overseas Private Investment Corporation’s Investment Funds Programme found that its African investments generated returns that, at 19.6 per cent a year, were as high as its Asian returns, and considerably above the levels achieved in other regions.[18] The AIG Africa Infrastructure Fund targets a return in the 20–25 per cent range, and some of the large energy infrastructure investors in the region target returns of more than 30 per cent. The high returns are, of course, a reflection of the perceived level of risk in the region, as well as of the shortage of investments (only the highest-return investments are undertaken), but they do indicate that Governments which invest in professionally managed investment funds for Africa, rather than in, say, American Treasury Bonds, do not need to compromise on returns.

Figure 1
Returns on investment in Africa as compared to other regions



Note: The number of countries is indicated in parentheses. EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MENA = Middle East and North Africa, AFR = Sub-Saharan Africa.
Source: IMF, *Balance of Payment Statistics 2001*.

25. In conclusion, Africa has strong investment needs in respect of infrastructure, and in particular, energy infrastructure. Infrastructure weaknesses are currently constraining competitiveness and supply capacity. Investments in infrastructure would not

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[17] UNCTAD, *World Investment Report 2004.*

[18] United States General Accounting Office, *The Overseas Private Investment Corporation’s Investment Funds Program*, May 2000.

only unlock considerable productive potential, but would also bring the promise of high returns, definitively higher than those that can be obtained on Western capital markets. Furthermore, many viable African companies are constrained in their access to credit because of domestic financial sector constraints, and making additional funding available would leverage their business opportunities. African investment funds, using windfall oil revenues from oil-exporting countries, would be well placed to benefit from these possibilities and, in the process, take a historic step towards boosting the continent's growth prospects.

Chapter II

A PROFESSIONALLY MANAGED INVESTMENT FUND, OWNED BY AFRICANS AND RUN BY AFRICANS: SETTING UP AND OPERATIONS

A. The principles

26. The Governments of African countries, preferably collectively, can set up an “umbrella fund” that then sponsors a series of specialized investment funds. They should be ambitious and target an initial total investment of a few billion US dollars (funds that are available as Governments are now placing them in traditional, less-leveraged savings instruments). The umbrella fund should be driven by African money, but the specialized funds could target additional funding from inside and outside the region, from other OPEC countries for an energy infrastructure development fund, from Middle East countries for an Islamic fund, and from development agencies for funds that invest in education, water or renewable energy projects as well as for a venture capital fund. Some of the funds may be suitable for low-risk institutional investors (thus giving an important new diversification opportunity to African pension funds and insurance companies), while others may be too risky for institutional investors but attractive to the African diaspora. In any case, many of the funds can also attempt to bring back some of the tens of billions of dollars of African money that have found their way, in often shady ways, out of the continent.

27. These funds should be professionally managed, with a long-time horizon to enable them to be suited to exploiting illiquid, less efficient markets such as venture capital, leveraged buyouts, oil and gas, timber, real estate and obviously infrastructure. Many Africans work for large and reputable international financial institutions, and if they are given the proper incentives,[19] many of them will be interested in contributing to Africa’s growth and development in this manner. The funds could well be based in major financial centres outside Africa (the Kuwait Investment Office, which manages the investment of the "surplus" oil revenue of Kuwait, has its headquarters in London). There should be no day-to-day interference in the funds’ management by Governments: they just supply the funding, and the money managers are only accountable for reaching target rates of return within clearly defined parameters. The funds’ investment decisions should be made in a transparent manner to ensure freedom from political interference.

28. The parameters of each specialized fund depend on its focus. A venture capital fund, for example, can expect a high failure rate but should target a high rate of return, and include medium-term exit strategies for all investments (a venture capitalist would normally want to move on to another investment within five to seven years). An energy infrastructure investment fund, on the other hand, would target lower rates of return and envisage a longer time horizon. An investment fund for trade transactions would focus on relatively low returns, but with risk exposure that would not exceed one year for most of its transactions.

29. One might even imagine that one of these funds is structured as a full-fledged investment bank. This has been proposed, in a similar context of “finding how to intermediate regional resources for the development of the region”, by the United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) for its region.[20] The arguments put forward by

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[19] Including in terms of measures that align their financial interests with those of the funds, for example in the venture capital fund, a “carried interest” for the fund's managers (the "carried interest" is the portion of any gains realized by the fund to which the fund managers are entitled without having to contribute capital to the fund; it would commonly be in the 20 per cent range).

[20] United Nations Economic and Social Commission for Asia and the Pacific, *Enhancing Regional Cooperation in Infrastructure Development*, ST/ESCAP/2408, March 2006, chapter VIII.

UNESCAP apply also to the African region, including its point that "identifying infrastructure projects, structuring them in a manner that makes them financeable, and taking care to meet the complex risk-mitigation requirements of different types of investors, are tasks better performed by a specialized institution". While this option should not be excluded in the longer run, setting up a bank tends to be a very long and tedious process, particularly if it is to be owned by several Governments (witness, for example, the discussions on the creation of a "South Bank of Developing Countries", which have been continuing for the better part of a quarter century[21]). Furthermore, a bank would be constrained by the rules of the New Basel Capital Accord, which, from 2007 onwards, will make it more difficult and costly to lend in situations that are deemed risky (and banks that want to reduce these costs have to show a proven track record). Investment funds are easier to create and operate than banks.

30. The funds would basically supply whatever forms of finance (including financial guarantees) are necessary for getting a project or an activity going. The major constraint in this regard would seem to be risk-carrying capacity, rather than capital per se. One would thus expect these funds to have a strong focus on the provision of risk capital rather than of simple loans: equity, venture capital, mezzanine loans and other subordinated forms of finance, as well as guarantees (to the extent that existing facilities are insufficient). One would also expect at least some of these funds to have sophisticated risk management capabilities, including in the use of techniques such as principal finance and alternative risk transfer. None of the funds would focus on investing primarily through the African stock exchanges (even though these exchanges may provide a good place for temporarily parking excess funds). Rather, they should invest directly in companies and projects that cannot easily raise funds on stock exchanges.

31. The focus of the funds should be on creating permanent wealth for Africa — not just in terms of generating a revenue stream that is higher than what can be expected through a more passive investment strategy, but also in terms of stimulating structural transformations that create the base for future growth. Investments should have an Africa focus, but that does not mean that they have to be entirely within Africa. Fund managers should also envisage investments that stimulate South–South trade and investments, enable transfer of technology to Africa (acquiring industrial technologies, patents and financial know-how), allow African exporters to capture new markets (by investments in the distribution chain), and so on.

32. Within this general parameter, fund managers should be free to invest where they want, taking a perspective that is regional or at least subregional (e.g. West Africa), rather than just focusing on the countries that put up the investment capital. It is quite possible that in West Africa, for example (where most of the funds would come from Nigeria), the best investment opportunities are in Nigeria, but this is not to say that the Nigerian fund providers should restrict the fund managers in their choices. There are two reasons to have a (sub) regional focus. Firstly, it would considerably strengthen fund managers' opportunity to "vote with their feet", and by investing less in countries with unfavourable legal and regulatory regimes, give a clear signal to Governments that improvements are needed. Secondly, oil-exporting countries need to build up an industrial base, and even in the case of a major economy such as Nigeria (which, to put it in perspective, has a GDP of only one sixth of that of the Netherlands), the national framework would be too constrictive: industries need to develop regional and international markets. Investing in regional infrastructure and economies allows the foundation to be laid for future regional market growth.

[21] See UNCTAD, *Enhancing South–South Trade and Investment Finance*, UNCTAD/WEB/DITC/COM/2005/2, 11 October 2005.

B. The proposed fund family

33. The proposal is that there be an "umbrella fund" that would act as a financing vehicle for a series of specialized funds, each with different operational strategies and target returns. This would help the African Governments that contribute the capital to diversify their portfolio; the "umbrella fund" could (re-)allocate its capital on the basis of the effectiveness of particular fund managers (managers should not only achieve target returns on capital, but also find sufficient investment-worthy activities); specialized managers with a track record in each of the investment areas could be attracted; some funds might be purely commercial, while others might include a "social entrepreneurship" component; and the process of leveraging African public-sector money could be optimized with additional funds from both within and outside the region.

34. Actual implementation would depend on available manpower — it would not be possible to start with all funds at the same time. The range of possible specialized funds is large. One can envisage, for example, one or more infrastructure funds (e.g. one for the energy sector, another one for transport), a fund for renewable energy projects, a venture capital fund, an Islamic finance fund, a trade finance fund, and so on.

35. An energy infrastructure fund, for example, could invest in the large energy-sector projects identified in the framework of the New Partnership for Africa's Development (NEPAD), and could also participate in private-sector-driven projects such as independent power plants or national distribution networks for bottled gas (propane and butane — this would go a long way to reducing pressure on woodlands). Such a fund could be a good candidate for investments from OPEC countries, both because in the short run, energy- sector investments would reduce the costs of energy to African consumers and thus reduce the impact of high oil-price levels,[22] and because in the longer run, such investments strengthen demand since they allow people to start using commercial sources of energy rather than their continuing to rely on traditional (firewood-based) resources. In addition to providing equity capital and other subordinated forms of funding, the fund could raise grant money from the international community to assist in the development of feasibility studies, and it could also provide sovereign risk guarantees where existing facilities (e.g. those provided by the export credit agencies, the World Bank's Multilateral Investment Guarantee Agency or the African Trade Insurance Agency) are insufficient.

36. One of the funds should provide venture capital. Venture capital is still very scarce in Africa, and this is one of the major constraints on the continent's private sector development — the more so since Africa's banks are by and large unwilling to invest in new ventures on the basis of a business plan alone, but instead require collateral. When one looks at how a venture capital fund works, it is easy to understand why a government entity cannot manage such a fund. Experience in developed countries shows that, typically, seven out of ten

Table 1
Typical portfolio of a venture capital fund

	#	Invested $ mm	Return multiple	Year 5 value $ mm	Return CAGR
"Dogs"	3	$3.0	0 x	$0.0	NA
"Walking Dead"	4	$4.0	2 x	$8.0	15%
"Cash Cows"	2	$2.0	5 x	$10.0	38%
"Home Runs"	1	$1.0	10 x	$10.0	58%
TOTAL	10	$10.0	2.8 x	$28.0	23%

Source: Venture Capital Online

[22] OPEC countries are under pressure from G-7 countries and others to provide relief to the poorer countries that have been suffering from high oil prices. See, for example, "Help Africa, Brown tells oil-rich", reporting on a call by the United Kingdom's Chancellor of the Exchequer, Gordon Brown, for OPEC countries to use some of their windfall oil earnings to help Africa (BBC News, 5 June 2005).

investments by a venture capital fund are failures (see table 1). Three out of ten investments completely fail within five years, and four others yield returns that are below the costs of capital. Only three out of the ten investments yield real returns, and one of these is the major contributor to the venture capital fund's return. This kind of risk is anathema to any government body.

37. Some funds may contain an element of subsidy or social entrepreneurship. For example, a fund that focuses on the development of local clusters (a case in point would be the provision of goods and services by local entrepreneurs to established export sectors such as oil and minerals) is a valuable vehicle for government policies. Part of the budget outlay for pursuing this policy could be spent on supporting the operations of the fund, for example to train local entrepreneurs or help their marketing efforts. Such a fund may also support the local content policies of many international investors (e.g. oil companies), which may then find it useful to pursue these policies in cooperation with the fund.[23]

C. Fund management

38. Fund management has to be strictly professional, free from any government interference. The highest standards that apply to the worldwide fund industry should be made to apply to the proposed African investment funds, including in terms of governance and incentive structures for managers.

39. To make this possible, the proper people need to be recruited, and a proper framework set up. Proper people need to be properly compensated, which means that salaries and other incentives should be in line with those offered by Western investment funds. The recruitment process should be handled without outside interference, and a good governance structure established to provide oversight of the actual functioning for fund managers without unduly distorting their investment decisions.

40. A proper framework is one that allows an investment fund to function properly, and in this domain, much work remains to be done throughout Africa. In particular, Governments should make it much easier for businesses to get started, and reduce the various forms of red tape that currently hamper growth and development.

41. There are various ways in which one can actually structure the management of a fund. One interesting possibility, proposed at a recent UNCTAD oil and gas conference,[24] would be to tie in the international oil companies in the management of funds. A major benefit of such an arrangement is that it would firmly commit the company (which is likely to be exposed to considerable outside scrutiny) to the success of the investment fund, which implies that it will assume a significant level of responsibility for getting professional and independent management, and would ensure that the fund's operations have a high level of transparency.[25] This can go a

[23] It should be noted that in a few cases oil companies have set up or supported investment funds to help them achieve their social objectives, for example to support local content development or stimulate the emergence of SMEs.

[24] Jean-François Casanova, Commodity Risk Management, *An Alternative View for Investing Huge Revenue Windfall*, 10th African Oil & Gas Trade and Finance Conference, Algiers, 2–5 April 2006.

[25] This can help retain the funds' independence, which in practice might otherwise be difficult to achieve, judging for example from the experience of the United States. Starting in 1989, the US Government set up a number of "enterprise funds" for Eastern Europe. It provided the resources but was not a member of any of the boards of directors, nor did it have any voice in investment decisions. The selected fund managers were initially resistant to government attempts at oversight. This proved unsustainable, however. Unfavourable press reports in 1993 about one of the funds led to a tightening of government controls, and

long way in securing the support of international agencies, which may have a high degree of justifiable scepticism about the ability and willingness of African Governments to use money wisely and will want to see as much distance as possible between Governments and a fund's investment decisions.

42. International oil companies have shown some interest in supporting the creation of investment funds. For example, in Kazakhstan ChevronTexaco works with Citibank to help, through improved funding, local small and medium-sized enterprises to access the oil company's supply chain. In Nigeria, Shell has worked with a local bank (Diamond Bank) and the International Finance Corporation to set up a fund with the same purpose. And one can argue that it is legitimate for host Governments to ask the large international investors in their countries to engage in activities of this nature as long as these investors have a comparative advantage compared with local government entities.

43. Indeed, the time for a more mature relationship between international oil companies and their host communities may have come. For a long time, the corporate social responsibility (CSR) policy of these companies focused on satisfying local communities and, to some extent, pleasing international public opinion. Relations with the Governments of the countries in which the investments were made hardly played a role; and these Governments typically had a laissez-faire approach vis-à-vis investors' CSR activities. Governments, however, have an interest in interacting more with investors on these issues, and the experience with (military) offset programmes may provide important lessons.[26]

44. In offsets, government agencies make their signing of a contract conditional upon certain counter-services from the seller. Offsets have been used for decades. In the beginning, offset programmes were very simple, seen by Governments as a form of charity that sellers bestowed on them. Later, Governments started to ask for some value addition, particularly in the form of local purchasing obligations for more complex (manufactured) goods. Subsequently, they asked for transfer of technology and the creation of local manufacturing centres by the foreign sellers (and they learned to become more and more specific in terms of exactly what they wanted the sellers to provide). Recent years saw the emergence of new kinds of counter-services, which required sellers to start analysing the economies of their client countries in order to determine where there was an underutilized potential, and where there were bottlenecks that they could help alleviate; all this they use to make value-added offset proposals, which have become a key driver in their ability to be selected as a supplier. Asking foreign oil companies to take responsibility for setting up viable investment funds that focus on addressing key bottlenecks in the host country's economy would fit well in this logic.

45. Investment funds do not need to be large in terms of staffing requirements. Even venture capital funds — probably the most labour-intensive form of investment — typically have only one manager for each $10 million or so under management. The Kuwait Investment Office (which manages the funds of the "Reserve for Future Generations") has some 100 staff, who manage an estimated $30 billion. Those figures give an idea of the organizational structure of

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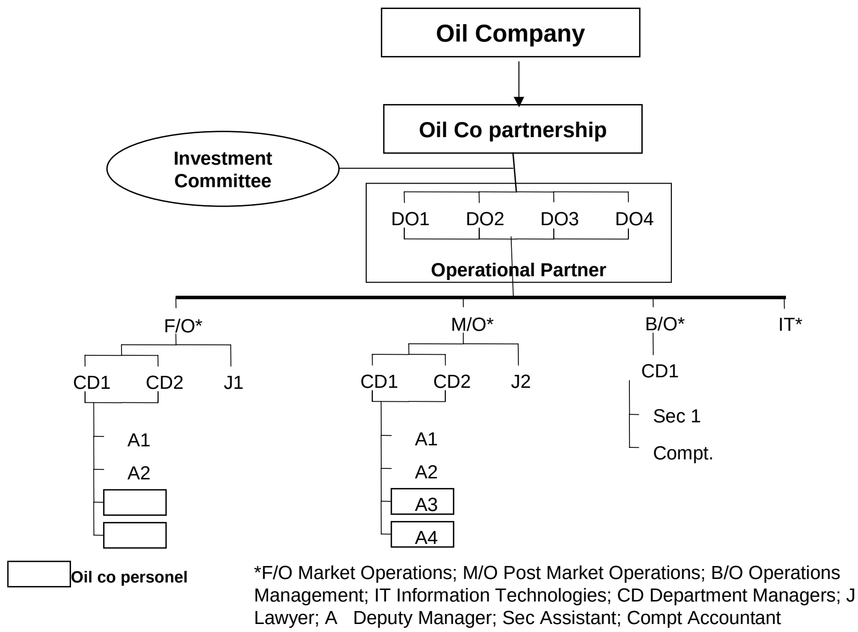
the funds agreed formally or informally, among other things, to a ceiling on salaries of fund officials, and to follow the rules and procedures that applied to direct US government assistance programmes (USAID, *The Venture Capital Mirage: Assessing USAID Experience With Equity Investment*, USAID Program Operations and Assessment Report No. 17, August 1996).

[26] See Lamon Rutten, "Can host Governments influence the developmental impact of investors' Corporate Social Responsibility programmes?", *Corporate Responsibility for Development: The Extractive Industries Angle*, UNCTAD/Brazilian Micro and Small Business Support Service, Saõ Paulo, June 2004.

Figure 2
Possible structure of an oil-company-supported investment fund



Source: Jean-François Casanova, Commodity Risk Management, *An alternative view for investing huge revenue windfall*,10th African Oil & Gas Trade and Finance Conference, 2-5 April 2006.

such a fund — in this case, under the overall management of an oil company — but the same structural issues and staffing levels (a minimum of 25 for a full-fledged fund) will apply also if Governments of oil-exporting countries have direct responsibility.

D. Value added and impact

46. By helping to remedy key constraints on Africa's supply capacity, the proposed funds will improve the ability of farmers and enterprises to respond to market opportunities. At a time when "aid for trade" is high on the political agenda (even though new actions to actually ease supply constraints in developing countries are mostly still on the drawing board), this should surely please both African Governments and the international community.

47. The funds' unique characteristics — private-sector-driven, but with privileged connections with African Governments — will allow them to play a strong catalytic role. Not only will they have a positive message function, signalling to investors from other parts of the world that Africa is open for business, but also they will be able to stimulate other investments in a direct way by taking risks that non-African investors are unwilling or unable to take.

48. Project-type investments can normally be structured into risk tranches, with each tranche corrresponding to a specific risk-return profile. High risks can in this way be stripped away from the majority of the investment capital. This would make it possible, for example, to convert a fairly risky investment project into a low-risk, investment-grade tranche (for which external finance can be found relatively easily) and a very high risk tranche that (with a high expected return) an African investment fund can take up. With relatively little capital, the investment fund can thus enable a large investment to be made. Risks can be sliced in many ways, and there are

several risk categories (including long-term risk exposure) with which an African investment fund, owned by African Governments, should feel much more comfortable than non-African investors. Such a fund can thus fill a significant gap in the current financial marketplace.

49. The investment funds are also likely to have a significant indirect impact, in that they will provide a feedback mechanism to African Governments regarding the quality of their policies, rules and regulations. Through their own investment decisions they can provide a litmus test for countries' business climate. Furthermore, their access to Governments should enable them to convey their messages on areas where improvement is needed to those who have the means to improve the situation.

50. Through their investment decisions, the funds will speed up the transfer of technology and expertise to Africa in the areas of manufacturing, services provision, marketing and financial know-how. They can bring techniques common to mergers and acquisitions, leveraged buyouts, structured finance and alternative asset management to countries that have little or no experience with such techniques. They will be able to enable their African partners (the companies in which they invest) to have an aggressive strategy in terms of obtaining technology from other parts of the world or penetrating new markets. Strategic risk management approaches will be brought to significant parts of local economies. Overall, the funds can act as a catalyst for the modernization of Africa's economy.

E. Why has the private sector not taken the lead yet?

51. Why, if the investment fund strategies described here would work and provide value for money for their investors (mostly Governments), has the private sector not yet set up such funds? Is there really a market failure that can be corrected through government action, or this is merely a mirage, with opportunities disappearing when looked at close-up?

52. The first reply was given a long time ago by John Maynard Keynes: "wordly wisdom teaches us that is better for reputation to fail conventionally than to succeed unconventionally".[27] Nonetheless, are there really enough viable investment opportunities in Africa? Donor agencies' experience with venture capital funds, for example, has not been favourable.[28] Problems were both internal and external. Funds were often too small and thus had overhead costs that were too high, the staff recruited had little relevant experience, and the administrative and bureaucratic requirements of the donor agencies often proved to be a poor fit for the enterpreneurial spirit that should guide an investment fund.[29] But as important was the often poor business climate, in terms both of unfavourable government policies, rules and regulations, and of a scarcity of interested entrepreneurs in the countries targeted.[30]

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[27] J. M. Keynes, *The General Theory of Employment, interest and Money*, Macmillan Cambridge University Press, 1936, chapter 12. In consequence, as Keynes notes, "It is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism, wherever investment funds are managed by committees or boards or banks".

[28] See, for example, USAID, *The Venture Capital Mirage: Assessing USAID Experience With Equity Investment*, USAID Program Operations and Assessment Report No. 17, August 1996; and European Commission, *Equity Investments and Overview of the Experience of Major Initiatives*, 2002.

[29] For example, the USAID evaluation notes that "The model followed in USAID projects for creating a venture capital company was so different from the typical fund manager's way of operating that USAID has not been able to interest mainstream venture capitalists in managing USAID projects".

[30] According to the USAID evaluation, "in most countries, entrepreneurs were extremely reluctant to sell a share of their equity".

53. It may well be the case that "capital in the form of foreign direct investment or domestic private capital per se is not the bottleneck for investments, but rather a combination of a lack of promising projects (often linked to lack of entrepreneurial and management skills), an insecure business environment (unstable currency, inefficient and unpredictable legal systems and regulations and lack of land registers etc. making it impossible to establish necessary collateral) and a lack/the cost of capital".[31]

54. However, the high returns on investments in Africa are not just an indicator of the high perceived risk of investments in Africa, but must surely also indicate that there are many investments with lower expected returns (but still high compared with the rest of the world) that are not happening. The room for venture capital may still be limited, but there are considerable possibilities in the infrastructure sector, with rents in the form of immediate efficiency gains and cost reductions that can be captured by an investment fund. It is important that African countries continue their reform processes to make their economies less hostile to investors, but that does not mean that it is too early to bring in additional capital; and the pressure of such capital waiting to be spent can act as an incentive for Governments to speed up legal and regulatory reform.

55. If indeed investment opportunities exist, one important reason why international private sector investors have not yet profited from them is the perception of risk and uncertainty that prevails with regard to Africa. An investment fund manager would probably not lose his or her job for writing off $10 million on an investment in China, because "everyone knows" about the opportunities in that country. But if that person lost one tenth of this in Nigeria, he or she could expect to be made redundant, as "everyone knows" how risky it is to invest in Africa. For this reason, Western investment fund managers let opportunities in Africa pass by. The impact of risk perception even goes one step further, in that the managers of, say, a public pension fund would be averse to placing part of their investments in a fund that focuses on Africa, because their stakeholders might not understand such a decision. An investment fund set up by African Governments, however, does not need to suffer from such a bias.

56. The actual risk exposure of an African fund may also be lower, because peer group pressure should reduce the sovereign/political risk of investments. Although an investment fund would not benefit from any specific "privileged creditor" status, one would expect African Governments to hesitate about taking decisions that would hurt the profitability of a fund in which such Governments (including perhaps itself) had a major stake.

57. Another reason why private sector investors may not have yet taken up the challenge of investing in Africa in a serious manner may be the traditional chicken-and-egg problem: most investors like liquid investments, so that if they want to close their position or otherwise change their strategy, they can easily do so. In effect, there are three pillars that they consider when assessing how to place their assets: risk, returns and liquidity. Less liquid instruments and markets, in consequence, attract fewer investors and as a result stay illiquid. Returns in Africa would appear to be good, probably even in relation to risk, and by making a conscious decision to invest and stay in the African market, the proposed umbrella fund and its specialized offshoots (particularly if funds are leveraged with investments from the African diaspora, OPEC countries and other sources) would in effect considerably strengthen the third pillar, namely liquidity. A vicious cycle could then be turned into a virtuous one, and Africa would become acceptable as an investment destination for a much wider public.

[31] Royal Norwegian Ministry of Foreign Affairs, *Evaluation of the Norwegian Investment Fund for Developing Countries (Norfund)*, Evaluation Report 1/2003.

58. An African fund would also be in a better position than foreign private funds to negotiate effective public–private partnerships, because of its easier access to key decision makers and because of a better public image (civil society would be less concerned about local governments giving away too much to foreign investments).

59. Furthermore, at least some of the funds may use criteria for their financial decisions that are different from those used by traditional investment funds. Investors normally have a benchmark rate of return (a "hurdle rate"), which for developing countries is often rather high, 20 per cent, 30 per cent or even more. The high target returns are seen as a way to compensate for risks (in contrast, banks tend to calculate explicit risk-adjusted rates of return). To calculate a project's return, investors apply a discount rate to future revenue — and this rate can be rather high, reflecting investors' desire to have a relatively fast return on their funds. Projects that promise to deliver discounted returns lower than the hurdle rates will not be financed. An African investment fund can legitimately set both the hurdle rate and the discount rate lower than would a foreign investor.

60. Hurdle rates can be set lower because firstly, the alternative use of funds by African Governments currently yields rather low returns, and secondly, as discussed above, the real risks that they would be running are lower than those for foreign investors. Discount rates can be lower because, from a public perspective, they should involve a judgement about the distribution of costs and benefits across generations. It should be a policy objective for Governments to create future earning possibilities for their citizens, and thus there is no reason for excessively conservative discounting of expected future revenue streams.

61. Public-sector investors must surely consider why they should go further than private-sector investors apparently dare to (at least, the latter have not dared expose large amounts yet: the various investment funds focusing on Africa together have less than $2.5 billion in capital). But in this case, both the reality and perception of risk will be more favourable to African public-sector investors than to international private-sector ones. Moreover, there are good economic reasons for such investors to apply different benchmark criteria to investments, which will show many new investment opportunities. If they set up well-staffed investment funds, with managers who have the capacity to make quick decisions without political or social interference, operating in accordance with the best practices of good governance, they can combine the mission of developing Africa with the goal of improving investment returns. Over time, when Africa develops, public investors' relative benefits in the investment fund business will surely disappear. The fund strategy described here can help bring that time closer.

CONCLUSION: MOVING FORWARD WITH AN INVESTMENT FUND STRATEGY

62. Crude oil prices have reached levels well above the prices on which most Governments of African oil-exporting countries based their budget decisions in the early years of the decade. Windfall gains for the Governments of African oil-exporting countries in 2004 and 2005 were more than $15 billion. This is a very significant amount compared with total foreign direct investment in sub-Saharan Africa of $9.1 billion (2002) to $12.8 billion (2004), or worldwide World Bank lending for fossil fuel projects in 2002 of $2.5 billion.

63. The traditional advice to those Governments is that they should save the "surplus" revenue — that is, put it into a stabilization fund which is invested safely in the Western capital market, for use in future bad years and for the use of future generations. But this confuses economic issues and governance issues. Boom–bust cycles should be avoided, but saving much of the revenue windfall is not a requirement for this. Instead, the Governments of African oil-exporting countries should re-inject at least part of their revenue surplus into strategic investments in Africa's future, investments that boost Africa's supply capacity.

64. Earlier oil booms resulted in expansionary government spending, with as a result many non-viable projects and heavy debt burdens. But the approach proposed in this paper — namely, not removing African funds from Africa, but just removing African government control from the day-to-day management of those funds — provides a better solution for the continent than the traditional stabilization fund approaches.

65. The proposed "umbrella fund" and its specialized investment funds are not a panacea. Improvement of the investment climate in Africa through policy, legal and regulatory reforms remains crucial, and Governments will need to develop explicit policies to deal with uncertain future oil price developments. But the funds' characteristics — professional, independent management; investments wherever in Africa there are viable projects; a focus on crucial supply constraints in the energy and transport sectors; a high-risk, high-reward, long-term perspective; high leverage and a drive towards public–private partnerships; and the inclusion of a mechanism for critical feedback to policymakers — will surely make a valuable contribution to Africa's growth and competitiveness. And as "investment opportunities in Africa are reported to offer some of the highest rates of return on investment, even on a risk-adjusted basis",[32] they will also yield greater value for participating African Governments than traditional investment approaches.

66. Ownership of the fund by many of the continent's largest economies will give it an important comparative advantage compared with the (much smaller) Western investment funds that now exist, in that political risk factors will play a much reduced role. By investing in Africa's economy and trade infrastructure as a whole (rather than just in their own countries), African oil exporters support regional integration in the continent and create new opportunities for non-oil exporters. Importantly, the creation of a fund of this nature will signal to Western capital providers that African leaders believe in the future of their continent, and are willing to "put their money where their mouths are". Such a fund can considerably boost Africa's growth and competitiveness, even in the short run, making it more likely that the continent can reach the growth rates necessary for meeting the Millennium Development Goals. With the fading of the high hopes born of independence, African leaders have become quite defensive, focused on coping with the great problems besetting their economies. The current oil windfall gives them the opportunity to show that they stand ready to take their continent's future in their own hands.

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[32] Arunma Oteh, Treasurer, African Development Bank, at a Corporate Council for Africa/US Exim conference, September 2004.